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**TELRIC NPRM  
Ex Parte Presentation**

April 14, 2004

# Existing TELRIC Pricing Methodology is Flawed

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- Relies on the wrong formulation of “forward-looking cost”
- Relies on a “most-efficient carrier” standard that is inherently ambiguous and inappropriate
- Results:
  - Distorts entry decisions by CLECs (bias toward UNE-P based entry)
  - Distorts investment incentives of ILECs and CLECs (toward under-investment by both in their own networks)

# Fundamental Differences Between ILEC and CLEC

Characteristic/Obligation	ILEC	CLEC
Must maintain ubiquitous network: carrier-of-last-resort (COLR)	✓	
Wholesale and some retail prices regulated; retail prices averaged statewide in some cases	✓	
Can develop forward-looking network from blank slate		✓
Critical operational/financial parameters (asset lives, depreciation rates, cost of capital) subject to regulation	✓	

# Forward-Looking Cost

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Current Interpretation	What it should be
Cost of a <i>hypothetical</i> “least-cost, most-efficient provider”	<p>Cost of an <i>actual</i> ILEC operating efficiently and subject to its <i>own</i> specific constraints and obligations, including COLR and service quality</p> <p><u>Study Impact</u> Must consider:</p> <ul style="list-style-type: none"><li>• <i>existing network in determining and as constraining cost</i></li><li>• <i>vacant locations</i></li><li>• <i>actual utilization levels or rates</i></li></ul>

## Forward-Looking Cost (cont'd)

<b>Current Interpretation</b>	<b>What it should be</b>
Cost of a scorched node loop network in which only wire center locations are “given”	<p>Cost of a loop network that assumes existing network routes and plant/equipment locations; reflects actual topography, terrain, rights-of-way and other constraints</p> <p><u>Study Impact</u> Must consider:</p> <ul style="list-style-type: none"><li>• <i>additional data points – actual equipment locations, e.g., terminals/interfaces, serving boundaries, and cable routes</i></li><li>• <i>actual placing and contract costs</i></li><li>• <i>recent structure sharing to represent future sharing opportunities.</i></li></ul>

## Forward-Looking Cost (cont'd)

<b>Current Interpretation</b>	<b>What it should be</b>
Cost of an ILEC assumed to maximize scale/scope economies by providing service ubiquitously	<p>Cost of an ILEC that has a COLR obligation and faces inter- and intra-modal competition which restrict it from serving volume at which scale/scope economies would be maximized.</p> <p><i><u>Study Impact</u> Must consider:</i></p> <ul style="list-style-type: none"><li>• <i>cost of capital that reflects risks appropriately</i></li><li>• <i>actual utilizations as conservative</i></li><li>• <i>CLEC requirements, e.g., demand for xDSL-capable copper loops and narrowband-capable loops</i></li></ul>

## Forward-Looking Cost (cont'd)

Current Interpretation	What it should be
Cost of an ILEC assumed to replace its facilities instantaneously with every introduction of new technology	<p>Cost of an ILEC assumed to replace its facilities not instantaneously but compatibly and efficiently.</p> <p><u>Study Impact</u> Must consider:</p> <ul style="list-style-type: none"><li>• <i>ILEC's forward-looking technology mix and vendor choice</i></li><li>• <i>engineering guidelines as reflected in ILEC's forward-looking network</i></li></ul>

## Forward-Looking Cost (cont'd)

<b>Current Interpretation</b>	<b>What it should be</b>
Cost of every network element is restricted by what its replacement would cost today ("replacement cost approach")	<p>Replacement cost approach modified by the proviso that ILEC's replacement network <i>may</i> retain elements of existing network only if it is efficient to do so</p> <p><u>Study Impact</u> <i>Must consider:</i></p> <ul style="list-style-type: none"><li>• <i>assumption of 100% of one "least-cost, most efficient" vendor or one type of technology may not be appropriate</i></li><li>• <i>constraints produced by the ILEC's existing network</i></li></ul>



# Efficiency

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- Fundamental to any reform of TELRIC methodology
  - “What is the efficiency standard that the [FCC] should use ... to achieve UNE prices that send the correct signals regarding investment, while still achieving the necessary level of cost recovery?” (NPRM, ¶57)
- No single efficiency benchmark can apply to both ILECs and CLECs
  - “Most Efficient” has no universal meaning
- Efficiency has several dimensions:
  - Price vs. cost
  - At a given point in time vs. over time
  - Carrier-specific vs. industry-wide

# Economic Efficiency: Concepts and Definitions

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## Static Efficiency

Optimal use of resources  
at any given point in time

### Allocative Efficiency (*Price*)

Absent market distortions, value placed on good or service (price) equals resource cost to produce it

### Technical Efficiency (*Cost*)

Output of good or service achieved at minimum resource cost (also, “productive” efficiency)

## Dynamic Efficiency

Optimal use of resources  
over time

Depends on R&D spending, product and process innovation, technological change, investment in human capital

Reflects changing competitive and demand conditions

# Static Efficiency Can Differ From Dynamic Efficiency

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- Uncertainty introduced over time by
  - Changing competitive landscape
  - Changing regulatory landscape
  - Technological progress and process innovation
  - Sunk investments
- Static efficiency and dynamic efficiency may be complementary, but trade-offs between them are equally probable

# Relationship Between Static and Dynamic Efficiency

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- They could be complementary
  - LEC invests in new services and processes for the longer run (pursuing dynamic efficiency) even while pursuing statically efficient strategies at any given time (e.g., parallel development of narrowband and overlay broadband networks)

## Relationship Between Static and Dynamic Efficiency (cont'd)

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- Or, there could be trade-offs
  - LEC minimizes facility (e.g., switch) cost at any given time, even though placing facility with capacity in excess of *current* demand may be dynamically efficient (e.g., to take advantage of steep discounts for new switch purchases)
  - Trade-off most likely in competitive environment in which LEC's future demand may be unpredictable, and more statically efficient strategy would be to size facility to expected near-term demand and upgrade/adjust as future demand materializes

# Consequences of Differences Between Static and Dynamic Efficiency

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- A carrier may be dynamically efficient but not statically efficient at discrete points in time
- Choices and actions that appear statically efficient at one point in time may not appear that way at a later time
- Prices that are imposed by regulation and justified as being statically efficient may still fail to provide sufficient incentives for
  - Incumbents to enhance their networks, service offerings
  - Competitors to develop alternative facilities-based networks

# Myth of the “Most Efficient” Carrier

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- “Most efficient” may be rhetorically pleasing, but ignores the fact that efficiency has several dimensions
  - Time
  - Carrier’s market presence and regulatory obligations
  - Technological continuity and compatibility
- *Substantial differences in circumstances mean that a **single** efficiency standard is **not** meaningful for both ILECs and CLECs*

# How to Apply Efficiency Standards

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- Acknowledge
  - intrinsic differences between circumstances of ILECs and CLECs
  - operational outcomes for ILECs and CLECs can differ *even when both operate efficiently*
  - different *static* efficiency standards may apply to ILECs and CLECs
- Adopt policies that maximize potential *dynamic* efficiency for industry as a whole, but do *not* attempt to impose dynamic efficiency standards on individual carriers



# Pre-eminence of Dynamic Efficiency

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- Dynamic efficiency takes full account of how carriers perform and customers fare over time
- Even when there are trade-offs between static and dynamic efficiency, empirical studies show that gains in dynamic efficiency are likely to exceed any losses in static efficiency
- Policymakers should focus on influencing the course of dynamic efficiency *of the industry* rather than on static efficiency *of individual carriers*

# Revised TELRIC Pricing Methodology

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- FCC's tentative conclusion that "TELRIC rules should more closely account for the real-world attributes of the routing and topography of the incumbent's network in the development of forward-looking costs" (NPRM, ¶52) *must be affirmed*
- The view that TELRIC should regard the costs of long-lived plant and equipment as sunk *must be rejected*

# Revised TELRIC Pricing Methodology (Cont'd)

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- Must incorporate the following when modeling the ILEC's actual forward-looking cost :
  - cost of capital that properly reflects risks
  - economic depreciation lives
  - ILEC's network design that includes *actual* cable routes, fill factors, structure sharing, etc.
  - ILEC's actual placing costs and vendor contracts
  - working and non-working lines

# Revised TELRIC Pricing Methodology (Cont'd)

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- Resulting TELRIC will
  - *not* be embedded cost
  - *not* be short run cost
  - produce UNE rates that will not distort entry decisions of CLECs and investment decisions of both ILECs and CLECs
  - encourage greater facilities-based competition and future innovation